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## FEDERAL VALUATION OF RAILROADS—1920-22

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Professor Clark's recent review of my essay "Railroad Valuation by the Interstate Commerce Commission," in the pages of this *Journal*, decries the note of skepticism with which that discussion closes. The present treatment seeks to give an analysis of outstanding events since the appearance of that volume in 1920, and to indicate the grounds on which the continuance of an attitude of skepticism is predicated. My previous conclusions can be adequately presented by a brief quotation:

It is too early to say that the Commission will not fulfil the promise to state single figures of value. It is even conceivable that the sum of cost of reproduction and the "present value" of land may in some cases be so reported. But it is not too early to raise the question of the real scientific validity of such figures (or any other figures reported) when based upon a "judgment" purporting to consider the irreconcilable totals and elements made final in the preliminary opinions. Certainly the totals now being published offer no basis for a figure of "final value." They represent a compliance with a statute, as that statute has been interpreted, but they represent nothing more. The first use of the rule in *Smyth v. Ames* was a frank guess. Will the Commission in making its final report speak with equal courage? Or will the Commission take refuge behind generality? It suffices for the present to recognize that the progress thus far made is not of a character to silence the skeptic who has small confidence in the conclusiveness or ultimate usefulness of the figures so expensively secured and so elaborately presented.<sup>1</sup>

I find nothing in the events of the past two years to justify a change in the preceding statement. The totals developed in the series of tentative valuations, the faulty premises of which are exposed at length in the essay, have been used as a basis for fixing "final value." That which in 1920 was alleged by the writer to be impossible of accomplishment has been accomplished. Thus, *prima facie*, is the critic confounded by the course of affairs. As compensation, however, he finds a gratifying element in the situation, since other conjectures in the paragraph quoted have been borne out by the practice of the Commission. While tentative figures of "final value" have been published, the Commission has not disclosed

<sup>1</sup> "Railroad Valuation by the Interstate Commerce Commission," p. 110. Hereafter cited as "Railroad Valuation, I.C.C."

the manner of determination. It has, indeed, taken refuge behind phrases quite as question-begging as the rule in *Smyth v. Ames*. A typical statement is that in the *Los Angeles & Salt Lake Case*, in which, for the first time, a single figure of value was attached to a property, as had been promised in the earlier formal opinions.<sup>1</sup> The Commission's conclusion in the *Los Angeles & Salt Lake Valuation*, since it represents that body's statement of its procedure under the act, is worth giving in the original language:

After careful consideration of all the facts, tentative and supplemental tentative valuations, including the excess cost of carrier lands, appreciation, depreciation, going concern value, working capital and materials and supplies, and all other matters which appear to have a bearing upon the value here reported, the value, as that term is used in the Interstate Commerce Act, of the property of the above named carriers, owned and used, and used but not owned, devoted by the carrier to common-carrier purposes, is found to be \$45,871,093. There is included in the figure named as final value, the value of certain lands used by the carrier for common-carrier purposes but owned by parties other than a common carrier, the present value of which is \$38,774.78. There is also included in the value above stated the sum of \$2,821,093 on account of working capital and materials and supplies.

The accomplishment, however, is somewhat dimmed when the manner in which this particular figure was hit upon becomes apparent. Where did this figure, purporting to be accurate to the final cent, come from? An answer was not found until a considerable number of "final value" figures had been published; when, in due time, the uniformity of the figures disclosed the method of that preparation. The figure is an "expert" guess—no more, no less. Such analysis of the figures as can be made indicates that the final value as reported for most roads is the sum of the cost of reproduction less depreciation, as reported by the Commission's engineers, plus the "present value" of the carrier lands as determined by the adjacent land test, plus 5 per cent of this total, then carried to the next lower or higher round figure (usually the latter) plus an allowance for working capital—cash, materials, and supplies. No allowance for intangibles, as such, appears, and there has been no apparent allowance made for any excess "cost of reacquiring" the carrier lands—the general statement of the Commission notwithstanding, unless the bulk 5 per cent may be accepted as such.

<sup>1</sup> "Railroad Valuation, I.C.C.," p. 8; *Texas Midland*, 1 Val. Rep. 1, 6; *Winston-Salem Southbound*, 1 Val. Rep. 187, 189; *Kansas City Southern*, 1 Val. Rep. 223, 229.

There are some exceptions to the application of the 5 per cent short cut, but these have been quite exceptional, and most important because showing that the Commission has, after all, been resorting to expediency. For the Elgin, Joliet & Eastern and its affiliated companies the percentage allowance was apparently  $7\frac{1}{2}$  per cent, the figure also for the Mobile & Ohio:

TABLE I

RAILROAD	COST OF REPRODUCTION LESS DEPRECIATION PLUS "PRESENT VALUE OF LAND"		"FINAL VALUE" LESS CASH, MATERIALS, AND SUPPLIES
	Plus 5 Per Cent	Plus $7\frac{1}{2}$ Per Cent	
Elgin, Joliet and Eastern.....	13,673,628	13,999,188	14,000,000
Chicago, Lake Shore & Eastern	18,796,215	19,345,904	19,250,000
Joliet & Blue Island.....	380,930	389,999	400,000
Mobile & Ohio.....	41,071,886	42,049,786	42,000,000

For the Rock Island a curious situation appears. There, for the parent company, the percentage allowance is  $2\frac{1}{2}$  per cent, although on the subsidiaries the full 5 per cent is allowed. The figure of final value less cash, materials, supplies, etc., has been fixed at \$243,000,000, whereas the  $102\frac{1}{2}$  per cent figure is \$242,837,659. These figures later called forth the remark that "the Rock Island is surprisingly sound with a practical correspondence of present value and recorded investment."<sup>1</sup> Undoubtedly the explanation of the shrinking of the percentage allowance from 5 per cent to  $2\frac{1}{2}$  per cent is the fact that a  $2\frac{1}{2}$  per cent allowance proved sufficient to "clear" the carrier investment account: which, on valuation date, was carried on the books as \$235,867,015. The application of the 5 per cent formula to the subsidiaries is apparent from the following figures:

TABLE II

Railroad	Cost of Reproduction Less Depreciation Plus "Present Value of Land" Plus 5 per cent	"Final Value" Less Cash, Materials, and Supplies
Keokuk & Des Moines.....	3,455,183	3,464,958
Choctaw, Oklahoma & Gulf.....	35,612,396	35,500,000
Rock Island, Arkansas & Louisiana....	10,747,985	10,750,000
St. Paul & K.C. Short Line.....	8,404,285	8,400,000
C.R.I. & Gulf.....	12,979,186	13,000,000
Peoria & Bureau Valley.....	1,641,120	1,650,000

<sup>1</sup> Consolidation of Railroads, 63 I.C.C. 455, Appendix, p. 644.

These figures are typical of those fixed for substantially all other companies for which figures of "final value" have been published. The figures for the larger companies are given below, but for the smaller companies the figures show similar calculations.<sup>1</sup> There can be no doubt concerning the method by which substantially all the figures have been built up.

TABLE III

Valuation Docket	Railroad	Cost of Reproduction Less Depreciation Plus "Present Value of Lands" Plus 5 Per Cent	"Present Value" Less Cash, Materials, and Supplies
4.....	Kansas City Southern	26,879,893	28,763,625
17.....	Georgia, Southern & Florida	9,367,610	9,500,000
31.....	Norfolk Southern	21,172,360	21,220,000
41.....	Chicago, Terre Haute & S.E.	19,507,501	19,919,076
73.....	Spokane International	4,724,948	4,750,000
132.....	St. Louis S.W. of Texas	22,825,504	22,850,000
142.....	St. Louis S.W.	25,286,248	25,550,000
144.....	Green Bay & Wn.	4,766,870	4,900,000
150.....	Bangor & Aroostook	20,741,043	20,658,484
151.....	Florida East Coast	45,128,339	45,500,000
159.....	New York, Phil., & Norfolk	10,432,022	10,500,000
164.....	Charleston & Western Carolina	9,807,930	9,800,000
168.....	Chicago, Indianapolis and Louisville	26,581,190	26,750,000
192.....	New York, Ontario & Western	31,986,446	32,500,000
202.....	Chicago & Eastern Illinois	62,057,847	62,250,000
207.....	Maine Central.....	39,923,700	40,000,000
209.....	Arizona Eastern	9,375,537	9,400,000
221.....	Boston & Maine	92,991,822	92,500,000
221.....	Boston & Lowell	26,679,284	26,500,000

Some of the deviations from the 5 per cent rule apparently are due to a desire to "cover" underlying security issues. Thus the 5 per cent rule which would give \$15,414,209 for the Toledo, St. Louis & Western, is deviated from by fixing a figure (less cash, supplies, and materials) of \$16,250,000. Quite conceivably the figure was stretched because of the existence of underlying bond issues, of which bonds to an amount of \$16,075,000 were outstanding as of December 21, 1919. It is possible also that the figures for the Louisiana Railway and Navigation Company (which, on the 5 per cent formula would make \$9,737,052) were stretched to \$10,500,000 on the same account—the

<sup>1</sup> The complete figures for the first 153 valuation dockets from which detailed figures, similar to those contained in the text may be worked up, are contained in Plumb Exhibits 1 and 1-A, Hearings, House Committee on Interstate and Foreign Commerce, 67th Cong., 2d Sess., "Railroad Valuations," pp. 84 and 86.

underlying bond issue being \$10,361,000. But for the great number of "valuations" the straight 5 per cent formula has been used in the calculation of the base figure of "final value."

To attack the figure of final value as thus determined as unscientific and inconclusive is easy. Undoubtedly it is true that much unwarranted weight will be given to figures which, as figures, deserve no special credence. Railroad apologists hurried to proclaim that the figures show that talk of watered stock had been much exaggerated. The counsel for the organized railway employees, Mr. Plumb, on the other hand, used the figures to discredit the \$18,900,000,000 tentative figure fixed in the Increased Rate Case.<sup>1</sup> The truth of the matter is that, taken alone, the figures prove nothing at all. The valuation made by the Interstate Commerce Commission has been a grand guess from beginning to end.

Disclosure of this method of making up the figure of "value" is important because of the relationship to the attack which the railroads promise to bring against any final figures predicated thereon. It is not probable that they can hope to stir the Commission from the stand that the plant and equipment of the carrier must be valued with deduction for accrued depreciation. Citation of authority from decisions and the testimony of distinguished railroad men have never in the past made a dent in the Commission's argument.<sup>2</sup> The argument is likely to be abandoned except by such "weak" roads as the Atlanta, Birmingham & Atlantic whose counsel have insisted that the "value" should be fixed at cost of reproduction new. The attack will go against the land figures.

The Commission, upholding the contention of its Bureau of Valuation that, under the opinion in the Minnesota Rate Cases, it could not determine the cost of "reacquiring" the carrier lands, had refrained from ordering compliance with that clause of the Valuation Act which directed a report of "the original and present cost of condemnation and damages, or of purchase in excess of . . . original cost or present value." Mr. Justice Hughes, in the Minnesota Rate Cases had said:

The conditions of ownership of the property and the amounts which would have to be paid in acquiring the right of way, supposing the railroad to be removed, are wholly beyond reach of any process of rational determi-

<sup>1</sup> *Ibid.*, p. 90; and the reply testimony of Mr. W. G. Brantley, attorney for the Presidents' Conference Committee, p. 123.

<sup>2</sup> "Railroad Valuation, I.C.C.," pp. 39-57 and the references there cited.

nation. The cost of reproduction method is of service in ascertaining the present value of the plant when it is reasonably applied, and when the cost of reproducing the property may be ascertained with a proper degree of certainty. But it does not justify the acceptance of results which depend upon mere conjecture.<sup>1</sup>

The Commission, finding that the estimate could be made "only upon inadmissible assumptions and upon impossible hypotheses," held that its "duty to abstain from reporting as an ascertained fact that which is incapable of ascertainment" was "clear."<sup>2</sup> Thereupon the Kansas City Southern had sought a writ of mandamus in the Supreme Court of the District of Columbia which should require the Commission to investigate and report the "present cost of condemnation and damages or purchase" of its right of way and lands. Beaten here, the carrier won in the Supreme Court, which held that the Commission must obey the mandate of Congress, since "Congress indisputably had the authority to impose upon the Commission the duty in question."<sup>3</sup> Thereupon the Bureau of Valuation undertook to do that which, on its importunings, the Commission had held "beyond the possibility of rational determination," calling for "inadmissible assumptions," and underlaid by "impossible hypotheses" as to subjects "incapable of rational ascertainment"—rather a large order. The Commission reported in its 1920 *Annual Report* that the result of the Supreme Court's holding was to prevent the fixing of a final value upon any property, or the service of other tentative valuation, until this figure could be ascertained.

It is the implication from the carriers' contentions that this language has been mere lip compliance, in fact meaning nothing, since the figures of value as fixed, though purporting to take into account the cost of reacquiring carrier lands, in fact, do not. The carriers will not fail to build up figures such as those given in the preceding tables to bolster up this contention, and there is also the action of the Commission in supporting the bill, subsequently enacted into law, relieving the Commission from the task of calculating the cost of reacquiring lands. Presumably the Commission's representatives would not urge that the Commission be deprived of evidence important in determining the figure of final value. The carriers,

<sup>1</sup> Minnesota Rate Cases, 230 U.S. 352, 452.

<sup>2</sup> Texas Midland, 1 Val. Rep. 1, 60; Kansas City Southern, 1 Val. Rep. 223, 258-63.

<sup>3</sup> U.S. ex rel Kansas City Southern Ry. Co. v. I.C.C., 252 U.S. 178.

however, have not come away from the court and legislative battle entirely empty handed, since they have figures reporting the "impossible" for a number of railroads (nearly 250). The Commission would seem to be estopped from longer declaring impossible of determination a "fact," or sets of "facts" which its own subordinate department did determine when required by court order. The figures reported were built upon the multiple basis, used in the state appraisals, which had called forth the comment from Mr. Justice Hughes in the Minnesota Rate Case.

No discussion of valuation developments since 1920 could be complete without reference to the general rate-levels decisions of 1920 and 1922. The Transportation Act had directed that the Commission,

In the exercise of its power to prescribe just and reasonable rates . . . initiate, modify, establish or adjust such rates so that the carriers as a whole (or as a whole in each of such rate groups as the commission may, from time to time, designate), will under honest, efficient and economical management and reasonable expenditures for maintenance of way, structures and equipment earn an aggregate annual net railway operating income equal as nearly as may be, to a fair return upon the aggregate value of the railway properties of such carriers held for and used in the service of transportation.<sup>1</sup>

Until such time as the final value for each carrier property should be determined, the Commission was directed to utilize the results of its valuation investigations in so far as deemed available, and to give due consideration to all elements of value recognized by the law of the land for rate-making purposes. To the property investment account it was adjured to give only "that consideration which under such law it is entitled to in establishing values for rate-making purposes." Acting under this power the Commission in the 1920 Increased Rate Case found aggregate values as follows:

Eastern group. . . .	\$8,800,000,000
Southern group. . . .	2,000,000,000
Western group. . . .	8,100,000,000
	<hr/>
	\$18,900,000,000

<sup>1</sup> Interstate Commerce Act, Sec. 15a. The Commission, in its opinion, Increased Rates, 1920, 58 I.C.C. 220, exercised the power granted in the Act to add one-half per cent for improvements to the rate of return ( $5\frac{1}{2}$  per cent) fixed by the act as "fair," until March, 1 1922. The 1922 decision fixed the rate at  $5\frac{3}{4}$  per cent. Reduced Rates, 1922, 68 I.C.C. 676, 679. Actually during 1920-21 the rates earned (aggregate figures) were much below the level set as fair in 1920. *Ibid.*, p. 687.



The aggregate book costs for the properties were then:

Eastern group . . .	\$9,038,194,615
Southern group . . .	2,183,923,124
Western group . . .	8,818,454,872
	<hr/>
	\$20,040,572,611

The round figures were adopted by the Commission only after considerable study. Commissioner Hall defended them:

All of the results produced by years of work on the part of the Bureau of Valuation were utilized, both as to particular roads and as to general tendencies and principles. These data covered (a) information as to the original cost of the property, (b) cost of reproduction new, (c) the accrued depreciation, (d) the amount of the investment, (e) the corporate histories of the properties, (f) the values of the lands, and (g) other values and elements of value, if any.

Those were found in the working papers in our Bureau of Valuation, which had accumulated during this period of time.

We utilized the results of the work of the bureau not only in cases where reports from the engineering, land, and accounting sections were all completed, our work being done by sections, but where substantial completion had been reached in the work of any of these divisions. Some idea of the magnitude of this special task of compilation may be had from the fact that 572 employee-days services were performed in the bureau of valuation in this phase of the work. . . .

We made a most serious and diligent attempt, irrespective of what was urged upon us in argument or in other ways, or presented in evidence—now, do not misunderstand me; we did not ignore the evidence; we took all the evidence and we considered it; it was our duty to do that, but we had to exercise judgment in weighing this evidence, and we reached conclusions which, after all, represent the composite of a number of minds.

The amount and market value of the bonds and stocks had been developed along general lines in the evidence, but was not especially studied by us.

In the compilation of the statistical matter, 494 clerk-days' labor was performed in the Bureau of Statistics. This is distinct, of course, from the labor that was done in the Bureau of Valuation. In addition, the entire time of Attorney Examiner Flynn was taken up for more than three months with this work.<sup>1</sup>

Such crude calculations, presumably, will be unnecessary when once the final valuations are fixed under the act, since it is provided that

<sup>1</sup> Modification of Transportation Act, 1920, Hearings Senate Committee on Interstate Commerce on S. 1150 and S. 2510, 67th Cong., 1st Sess., p. 677.

"Whenever, . . . the value of the railway property of any carrier held for and used in the service of transportation has been finally ascertained, the value so ascertained shall be deemed by the commission to be the value thereof for the purpose of determining such aggregate value." The individual final valuations are then the key to the problem.

They are also important for the exercise of the power to "recapture" excess earnings:

If . . . any carrier receives for any year a net railway operating income in excess of 6 per centum of the value of the railway property held for and used by it in the service of transportation, one half of such excess shall be placed in a reserve fund established and maintained by such carrier and the remaining one half thereof shall . . . be recoverable by and paid to the Commission for the purpose of establishing and manufacturing a general railroad contingent fund. . . .

It is not hard to see why such a carrier as the Union Pacific, which will, undoubtedly, face the problem of litigating the excess-earnings clause, should insist that the value of a railroad property can be measured only by capitalizing earnings. How such a theory can be squared with the logical difficulty that a value used for fixing earnings cannot be measured by capitalizing earnings is not easy to see. But procedure in the whole valuation controversy is not notable for rigid adherence to logical analysis. Perhaps "value" for rate-making purposes and "value" for the recapture of excess earnings will be fixed upon different premises. Only the seemingly inevitable judicial opinion can say.

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